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FRC consults on changes to FRS 102 to reflect recent changes in IFRSs

Contents

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In a nutshell

The FRC has published a *Consultation Document Triennial review of UK and Ireland accounting standards – Approach to changes in IFRS*. This forms part of the first triennial review of FRS 102 and sets the direction of travel for UK GAAP. Areas under discussion within this Consultation include revenue recognition, leases and impairment model for financial assets.

Comments on the Consultation Document are invited by 31 December 2016.

Background

When FRS 102 was first issued by the FRC, the FRC indicated that the standard would be reviewed every three years. The Consultation Document is part of the first triennial review of the standard and it involves considering changes to IFRSs and whether FRS 102 should be amended to reflect those changes.

The triennial review is now in progress and the FRC is keen to hear stakeholders' views on possible improvements to FRS 102. The FRC has already invited feedback and suggestions for improvements arising from experience of applying FRS 102 to date. Such feedback can be sent to **ukfrsreview@frc.org.uk**. These comments will be considered when developing proposals for incremental improvements in the Phase 1 FRED.

The triennial review process involves considering a wide range of potential sources of improvements and clarifications. This specific consultation focuses on one of those sources. It considers whether and to what extent FRS 102 should be updated for recent changes to IFRSs.

Objectives and principles

The FRC's overriding objective for the suite of new UK GAAP standards is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. In meeting this objective the FRC applies five principles to which it now proposes some limited changes. The principle that financial reporting standards should reflect up-to-date thinking and developments in the way that entities operate and the transactions they undertake has been modified to clarify that such improvements must be balanced with stability.

The key principle for the purposes of the current consultation is that financial reporting standards should have consistency with international accounting standards through the application of IFRS-based solutions unless an alternative clearly better meets the overriding objective (as stated above).

The focus of this consultation

The triennial review is an opportunity to make improvements to FRS 102. These will be identified through a variety of sources including implementation experience and wider developments in financial reporting. Some amendments might be viewed as incremental while others might be viewed as more fundamental. All amendments will be subject to public consultation through the issue of FREDs. The FRC is seeking stakeholders' views in advance of developing detailed proposals.

As FRS 102 has been developed to have consistency with IFRSs, one of the potential sources of amendments to FRS 102 is a review of recent changes to IFRSs. The Consultation Document focuses on how the FRC should respond to changes in IFRSs when updating FRS 102.

The FRC expects to develop two FREDs, taking into account all the feedback received:

- FRED *Triennial review 2017 Phase 1 – Incremental improvements and clarifications* to be issued towards the end of the first quarter of 2017; and

- FRED *Triennial review 2017 Phase 2 – Expected loss model and leases* to be issued towards the end of the third quarter of 2017.

The Phase 1 improvements are expected to be effective for accounting periods beginning on or after 1 January 2019. The more significant changes to FRS 102 proposed in Phase 2 are expected to be effective for accounting periods beginning on or after 1 January 2022. This is to give entities more time to prepare for transition and to be able to learn from the experience of listed groups already applying the IFRSs on which the amendments will be based.

The effective date for the Phase 2 amendments is expected to coincide with the second triennial review of FRS 102. However, the FRC notes that current expectations are that this will not replace the second triennial review which will still commence in 2019.

When developing the Consultation Document, the FRC has considered all changes to IFRSs including new standards, amendments to standards and Interpretations. The main issues considered are summarised below. Further details can be found in the Consultation Document.

PHASE 1

IFRS 3 Business combinations

The requirements of FRS 102 for business combinations are mainly taken from the IFRS for SMEs and are based on the requirements of IFRS 3 prior to its revision in 2008. The FRC does not propose any changes to FRS 102 to increase consistency with IFRS 3 as revised in 2008. This is partly as a result of issues about consistency with UK company law and partly due to some issues identified by the post-implementation review of IFRS 3 including cost/benefit considerations of separating more intangible assets from goodwill.

IFRS 10 Consolidated Financial Statements and IFRS 11 Joint Arrangements

The definitions of 'control' and a 'subsidiary' in FRS 102 are taken from the IFRS for SMEs and were derived from the requirements of IAS 27 before they were superseded by IFRS 10. The FRC proposes to make limited amendment to FRS 102, as part of the Phase 1 FRED, to update the control model, principally by revising the definition of control to be consistent with IFRS 10 and providing guidance on its application. However, the FRC notes that this will be "in addition to any specific circumstances in which company law requires group accounts to be prepared".

FRS 102 already includes a variant of the investment entity exemption in IFRS 10 although it focuses on the nature of the investments held rather than the nature of the investor. The FRC does not propose to change this aspect of FRS 102 which was developed to be consistent with company law.

The FRC notes that the changes to the definition of control will not have a practical effect on the accounting for many subsidiaries and joint arrangements. It suggests that entities may be able quickly to establish when there might be an impact. Improvements were made to the definition of control to address concerns about the boundary of the reporting entity. The FRC therefore believes that, when relevant, these improvements should also apply to entities applying FRS 102.

Observation
The FRC anticipates that many entities will be able to determine cost-effectively whether any changes to FRS 102 impact their accounting, therefore limiting the cost of implementation. However, there is an inevitable cost of becoming familiar with a new set of requirements, especially for those not already familiar with IFRS 10. Also, there is an existing tension between the requirements of FRS 102 and the legal definition of a subsidiary undertaking which will be affected but not resolved by this proposed change to FRS 102.

IFRS 13 Fair Value Measurement
FRS 102 was amended in March 2016 to require financial institutions to provide information in accordance with a hierarchy which is consistent with the one in IFRS 13. As part of the March 2016 amendments, the FRC has already indicated that paragraph 11.27 of FRS 102 (which sets out a process for estimating fair value) would be reviewed for greater consistency with IFRS 13. The FRC will also consider the consistency of key definitions. If the definition of fair value under FRS 102 is amended to be consistent with the IFRS 13 definition this could impact the measurement of derivative liabilities. This is because the IFRS 13 definition is based on the price at which a liability can be transferred rather than settled, and so may result in larger adjustments for 'own credit' risk. These amendments will be included in the Phase 1 FRED. The FRC does not propose to amend FRS 102 to incorporate further disclosure requirements of IFRS 13.

IFRS 15 Revenue from Contracts with Customers
IFRS 15 includes a five-step process for recognising and measuring revenue. The FRC notes that revenue is a key piece of performance information and that users of financial statements are likely to value consistency of approach to the recognition and measurement of revenue. Therefore, the FRC proposes that, in the longer term, the revenue requirements of FRS 102 should be aligned with IFRS 15. However, it recognises that it would be premature to put forward detailed proposals at this stage. Therefore, the FRC is not proposing to make significant changes to accounting for revenue as part of the current triennial review but will revisit this for the next triennial review in 2019.

However, the FRC is proposing more limited amendments to incorporate requirements of IFRS 15 about how to allocate revenue to the components of a single transaction to reflect the substance of that transaction. The guidance would be likely to highlight the need to consider all goods and services that have been transferred and recommend the use of relative stand-alone values as a basis of allocation. These amendments will be included in the Phase 1 FRED.

Observation
The Consultation Document mentions that entities applying FRS 102 might be members of a group applying IFRSs in the consolidated accounts and makes a point about eliminating the need for consolidation adjustments. This may be of limited significance given that many such entities are now applying FRS 101. However, this is an area in which FRS 102 does not provide much guidance so it is likely to be viewed as a helpful improvement.

IFRS 12 Disclosure of Interests in Other Entities
FRS 102 already requires fewer disclosures than IFRSs. There are also disclosure requirements in the law about interests in subsidiaries and associates and other 'participating interests'. The FRC notes that, to date, there is no evidence that users of financial statements prepared in accordance with FRS 102 require additional disclosures about other entities. Therefore, the FRC does not propose to amend FRS 102 following the issue of IFRS 12.

PHASE 2
IFRS 9 Financial Instruments
The amendments to FRS 102 in July 2014 took into account the IASB's work on the classification and measurement and hedge accounting phases of IFRS 9. As part of the triennial review, the FRC will consider how the impairment phase of the IFRS 9 project should impact FRS 102. In addition, the FRC will consider feedback on its classification and measurement model as part of the first phase of the triennial review.

The Impairment model in IFRS 9 that was finalised in July 2014 is an expected loss model. The IFRS 9 model was developed in response to criticism of the IAS 39 incurred loss model following the financial crisis and will result in the earlier recognition of credit losses. The change in approach to impairment will have the greatest impact for financial institutions. The FRC notes that consistency with IFRS 9 would promote consistency between financial institutions applying IFRSs and those applying FRS 102.

The FRC's preferred approach is to require financial institutions (as defined in FRS 102), or a sub-set of financial institutions such as banks and building societies, to apply the requirements of IFRS 9, whilst replacing the existing impairment requirements of FRS 102 for all other entities with new requirements based on the simplified approach in IFRS 9.

The FRC mentions two other possible approaches. The first is to incorporate detailed requirements (based on IFRS 9) into FRS 102 in a similar way it dealt with hedge accounting requirements. The second is to require financial institutions, or a sub-set of financial institutions such as banks and building societies, to apply the impairment requirements of IFRS 9 and not to make any other changes to the current impairment requirements of FRS 102 unless there was evidence that they were not operating effectively. The FRC is inviting comments on which of these approaches it should adopt.

The FRC proposes to delay the effective date for the expected loss model until 1 January 2022 to give entities time to prepare for the change and to learn from the experiences of listed groups applying IFRS 9. In addition the FRC proposes to allow entities applying the measurement and recognition requirements of IAS 39 to continue to apply them until this date.

Observation

The objective of this proposal is that building societies (and small financial institutions such as unlisted banks) applying FRS 102 should have to apply the same impairment model as listed banks. However other entities, for example smaller corporates in particular, may find the increased complexity challenging with limited benefit to the users of financial statements.

IFRS 16 Leases

IFRS 16 has a single model for lessee accounting and requires more leases to be recognised as an asset and a liability than previously. It has not yet been endorsed for use in the EU.

The FRC notes that IFRS 16 is intended to provide enhanced information for users of financial statements by giving more accurate information about the financial position of an entity. It will allow better comparison between companies that borrow to finance assets and those that lease assets. The FRC therefore proposes to amend FRS 102 to incorporate the requirements of IFRS 16. The FRC notes that IFRS 16 includes a practical expedient for short life assets and low value leases. It will give particular consideration to how the low value expedient might operate in FRS 102.

The FRC realises that entities will want time to prepare for implementation and to assess the impact on current, and proposed, leases and similar contracts. Therefore, the FRC proposes to delay the effective date for these amendments until 1 January 2022. The detailed proposals will be included in the Phase 2 FRED.

Observation

IFRS 16 becomes effective for accounting periods beginning on or after 1 January 2019. It has not yet been adopted by the EU. It seems appropriate in the long-term to converge FRS 102 with IFRS 16 to address long-standing concerns about the transparency around off-balance sheet liabilities. However, in the short run it would be more reasonable and practical to let UK listed companies gain the experience of applying IFRS 16 first before extending it to other entities.

Other issues

The FRC acknowledges that various issues concerning financial instruments could be reviewed as part of the triennial review. These include the definition of a financial institution and the classification of financial instruments (i.e. between basic and non-basic). The FRC also says it will reconsider the layout of sections 11 and 12 of FRS 102.

Observation

The definition of a financial institution has unexpectedly become one of the most challenging aspects of FRS 102. This arises from a tension between a list of entities that are financial institutions and a 'catch all' provision which seems much broader than that list. It is welcome that this will be reconsidered.

The definition of a basic financial instrument has also been the subject of much discussion. It is not expected that the approach will be significantly amended. However, it is welcome that some of the issues arising in practice, which sometimes give counter-intuitive answers, will be addressed.

The point about 'layout' is presumably intended to deal with the confusion caused by some financial instruments (e.g. investments in ordinary shares) being within the scope of section 11 but nevertheless required to be accounted for at fair value through profit or loss.

The FRC is inviting comments about accounting for share-based payment transactions although it is not proposing any amendments in this respect. It would be "keen to understand any views about its practical implementation and cost-effectiveness, and whether any alternatives could be provide useful information to users".

Observation

Accounting for share-based payment transactions under FRS 102 is consistent with old UK GAAP so should not provide any new challenges except in the case of small companies applying Section 1A of FRS 102. Companies applying the FRSSE were not subject to these requirements but just had to disclose details of the arrangements. The FRC's question on this highlights some continuing concern about the cost/benefit implications of applying these requirements to companies which do not have a quoted share price. However, the other side of the coin is that if companies offer these benefits to employees, they should have an idea of the value of those benefits.

The Consultation Document also refers to the accounting policy choice for government grants between an accruals model and a performance model. However, it concludes that the time is not right for a change without an internationally agreed solution.

Finally, the Consultation Document mentions that the FRC will review the disclosure requirements of FRS 102 with a view to seeking greater alignment with company law. This is to be consistent with the approach taken in Section 1A for small companies. The FRC will also consider whether, in the light of experience, any requirements should be amended.

Invitation to comment

Comments on the Consultation Document have been requested by 31 December 2016.

The **press release** and **consultation document** are available on the FRC website.

Further information

All our past newsletters can be found **here**.

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